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TRADE SUMMARY

In 1999, the United States trade deficit with Russia was nearly \$4 billion, an increase of \$1.8 billion from the 1998 deficit of just over \$2.1 billion. U.S. merchandise exports to Russia were \$1.8 billion in 1999, a decrease of \$1.7 billion (48.5 percent) from the level of U.S. exports in 1998. Russia was the United States' 41st largest export market in 1999. U.S. imports from Russia accounted for approximately \$5.8 billion in 1999, a decrease of \$71 million (1.2 percent) from 1998. The stock of U.S. foreign direct investment in 1998 was \$1.1 billion, a 46.6 percent decline from 1997.

The U.S.-Russia Trade Agreement governs all trade relations between the United States and Russia. The USSR signed the agreement in June 1990, and it was approved by the U.S. Congress in November 1991. The agreement, however, never reached ratification during the existence of the USSR, and the United States offered the agreement (with minor technical changes) to each of the emerging states of the former Soviet Union. Russia's parliament approved the agreement, making it possible for the United States to extend Most-Favored-Nation (now Normal Trade Relations or NTR) status to Russia on June 17, 1992. Russia is in the process of negotiating terms of accession to the World Trade Organization (WTO). By the end of 1999, the government of Russia had met nine times with WTO members in working party meetings. Russia tabled its initial goods and services market access offer in February 1998 and October 1999, respectively, and will discuss its plans to bring its laws into line with WTO provisions at the tenth Working Party session, expected to meet in the first half of 2000.

IMPORT POLICIES

Frequent and unpredictable changes in Russian customs regulations have created problems for foreign and domestic trade and investment, and

a burdensome import licensing regime for alcohol has depressed imports in that sector. However, at the end of 1999, the most significant factor affecting U.S. exports was the difficult economic situation in Russia subsequent to the August 1998 financial crisis. The devaluation of the ruble puts imports at a price disadvantage, and reduced consumption overall has also depressed imports. Other significant negative developments in the foreign trading environment include the reduced availability of trade and non-trade finance and disruptions to the distribution chain.

Since 1995, Russian tariffs have generally ranged from five to thirty percent, with a trade-weighted average in the range of 13 to 15 percent. In addition, excise and value-added taxes (VAT) are applied to selected imports. The VAT, which is applied to the price of the import plus its tariff, is currently 20 percent. Some food products have a VAT rate of 10 percent. Throughout 1999, some tariff revision occurred. In some cases tariffs dropped on inputs needed by Russian producers in the electronics and furniture business. On the other hand, there have been sharp hikes in tariffs on sugar and pharmaceuticals, including high seasonal tariffs on raw and processed sugar. In particular, compound duties with minimum tariff levels on poultry enacted in 1998 had the effect of increasing *ad valorem* duties after the fall in poultry prices in 1998-99. The Ministry of Trade, supported by the State Customs Committee, has proposed the reduction of some of Russia's higher tariffs, noting that very high tariffs only lead to evasion. The government, however, has been reluctant to approve wholesale reductions in tariffs given acute revenue concerns, as customs duties account for a significant percentage of total federal revenues (about 20 percent).

Other Russian tariffs that have stood out as particular hindrances to U.S. exports to Russia include those on autos, where combined tariffs and engine displacement-weighted excise duties can raise import prices of larger U.S.-made

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passenger cars and sport utility vehicles by over 70 percent. The Russian government continues to make waivers of aircraft import tariffs for purchases by Russian airlines contingent on those airlines' purchases of Russian-made aircraft.

Financial Sector Difficulties and the Ruble

Russia's overall imports slumped by over 37 percent from January to October 1999 compared to the same period of the previous year. The devaluation of the ruble in August 1998 and the reduced purchasing power of Russian consumers played the greatest role in that decline. U.S. exports to Russia decreased by an even larger margin in 1999, although there was some recovery in the later months of 1999. Many exporters remain cautious about entering the Russian market due to the reduced availability of trade finance and bad experiences with payment and clearance after the August 1998 financial crisis, although these problems became less common in 1999.

Throughout 1999, the government continued tight controls on alcohol production, including import restrictions, export duties, and increased excise taxes. Many of these controls are intended to increase budget revenues. While in some cases the government has imposed compound duties, in other cases it is resorting to pure *ad valorem* duties. According to a government resolution issued in December 1999, wine importers will have to pay a single 25 percent duty, beginning in April 2000. Presently different per liter duties are levied on different types of wines. This decree will effectively increase duties on importers of more expensive wines.

Import licenses are required for various goods, including ethyl alcohol and vodka; color TVs; sugar; combat and sporting weapons; self-defense articles; explosives; military and ciphering equipment; encryption software and related equipment; radioactive materials and

waste including uranium, strong poisons and narcotics; and precious metals, alloys and stones. In 1999, new import licensing requirements were added for raw and processed sugar. Most import licenses are issued by the Russian Ministry of Trade or its regional branches, and controlled by the State Customs Committee. Import licenses for sporting weapons and self-defense articles are issued by the Ministry of Internal Affairs.

In September 1999, the State Custom Committee issued a decree restricting points of entry for poultry shipped to Russia from any country that does not have a direct land route to Russia. While implementation of this decree has been postponed until at least February 2000, poultry shipped from the United States and some other major exporting countries, not including the European Union, would be required to enter Russia through one of 30 specified sea ports. This could put U.S. suppliers, who often ship to an intermediate country and then transport via land to Russia, at a disadvantage. The continued delay in implementation of this decree has left the industry in an uncertain environment. The decree raises issues under the U.S.-Russia Trade Agreement, which calls for MFN status in customs issues.

The Ministry of Communications and Information's Order No. 8 mandates that certain types of switching equipment be manufactured only in Russia. This has forced some U.S. telecommunications suppliers to set up manufacturing operations or joint ventures in Russia, rather than import the equipment.

STANDARDS, TESTING, LABELING AND CERTIFICATION

U.S. companies report that Russian procedures for certifying imported products and equipment are non-transparent, expensive, and beset by redundancies. Russian regulatory bodies generally refuse to accept foreign testing centers' data or certificates. U.S. firms active in

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Russia have complained of limited opportunity to comment on proposed changes in standards or certification requirements before the changes are implemented. Russian standards and certifications bodies have begun to work more closely with the American Chamber of Commerce in Russia to provide relevant information. Occasional jurisdictional overlap and disputes between different regulatory bodies compound certification problems. In 1998, the Russian government established an inquiry point for regulations covered by the Technical Barriers to Trade (TBT) Agreement in the World Trade Organization (WTO). On July 31, 1998, new amendments to Russia's Law on Certification of Products and Services went into effect which Russia claims generally meet requirements of the TBT Agreement. The law allows for manufacturer declaration of conformity for a limited number of products. However, this option is not yet available in practice.

The current Russian product certification regime makes it difficult to get products into the Russian market and creates barriers to Russian exports as well. Manufacturers of telecommunications equipment, construction materials and equipment, and oil and gas equipment continue to report serious difficulties in obtaining product approvals. Certification is a particularly costly and prolonged procedure for telecommunications equipment. Telecommunications equipment is tested for compliance with standards established by both Gosstandart and the State Committee on Communications (Gostelkom). This process typically takes 12-18 months. Self-certification by manufacturers is currently not possible. Order 113, introduced by Gostelkom in July 1998, requires all mobile communications systems in Russia to convert to the Russian Glonass system by July 1999. This will require costly reconfiguration of systems by U.S. telecommunications companies to maintain access to the Russian market.

Russian agencies have begun requiring the use of holographic marks of conformity on a small number of goods and on copies of certification documents. Foreign businesses have complained that this requirement is costly and unnecessary, involves unclear rules, and that Gosstandart has not coordinated administration sufficiently with the customs service.

Requirements of the Russian Veterinary Department are burdensome and sometimes of questionable scientific or food safety value. As Russia looks to WTO accession, the Veterinary Department will need to develop a more transparent, science-based and WTO-consistent food inspection system. In 1998, biotech food products attracted the attention and increased scrutiny of Russian import authorities. Selected products were required to undergo private-sector-funded government tests in order to maintain necessary certification to remain on the market. Companies were required to fund food safety studies of questionable merit conducted by the Institute of Nutrition in order to receive necessary certification from the Health Ministry. In late 1998, the interministerial government commission responsible for issues related to genetic engineering began to form working groups to examine issues related to biotech including food safety.

Technical level discussions with U.S. officials on phytosanitary import requirements for planting seeds have resulted in a positive change in the Russian government position, making it possible to import U.S. corn and soybean seeds.

GOVERNMENT PROCUREMENT

The Russian government has virtually eliminated the Soviet practice of centralized imports through state-owned foreign trading companies. Some large-scale trade deals for state needs (such as a recent food for natural gas debt deal between Russia and Belarus) still take place. Typically, however, the government

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awards the right to implement such deals on its behalf to private or quasi-private trading houses.

Russian ministries and government agencies are frequent purchasers of equipment, goods and services for their own needs or for the needs of various domestic organizations or groups (i.e., the military, regional health organizations, or population centers located in remote areas). In April 1997, the government established procedures for public tenders for some government procurement. A government procurement bill, based on competitive bidding, is also being considered in the Duma. Domestic suppliers currently are not accorded many official advantages or privileges in competing for government procurement. Nonetheless, the Russian government's strong political bias toward supporting domestic industries may work in favor of Russian suppliers. An example of such bias occurred in 1997 when government agencies were directed to use only domestic automobiles (a program which ran into problems and is currently not strictly enforced).

On January 13, 1999, an amendment to the Federal Law on Communications went into effect, which appears to vaguely exhort government agencies purchasing communications equipment in efforts to give priority to systems using Russian-produced equipment. The impact on U.S. exports will depend on implementation of the new law; U.S. companies are not currently expecting a large impact.

EXPORT SUBSIDIES

The Russian government's industrial policy guidelines emphasize export promotion and import substitution. In practice, there has been limited budgetary funding for such projects, and the programs that do exist are designed to provide support to industries which export, rather than targeted export subsidies. In December 1999, Acting President Putin proposed the establishment of a Russian export

credit guarantee agency. Russia has no explicit export subsidies on agricultural products.

INTELLECTUAL PROPERTY RIGHTS PROTECTION

Estimated losses to U.S. industry due to intellectual property piracy exceeded one billion dollars in 1999, according to industry sources. During the summer of 1998, the U.S. motion picture industry estimates that video piracy in Russia rose by 20-30 percent to a level of approximately 80 percent, in the aftermath of the financial crisis. Only recently have these numbers begun to come down.

With the exception of protection of pre-existing copyrighted works and sound recordings, the Russian government has made considerable progress in constructing a legal framework to bring Russia up to world standards in the area of intellectual property protection. Since 1992, Russia has enacted generally acceptable laws on trademarks and appellations of origins, patents, and protection of semiconductor chips, computer software, and copyrights. Russia is a member of the Paris Convention, the Universal Copyright Convention and other major multilateral intellectual property conventions. In 1995, Russia acceded to the Berne and Geneva Conventions. The U.S.-Russia bilateral trade agreement also requires Russia to provide protection for intellectual property. Russia is in the process of joining the WTO, and as a new member will be required to meet obligations under the WTO's Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS Agreement) immediately upon accession.

Although there have been signs of progress over the past year, there is a troubling lack of effective anti-piracy action by Russian law enforcement agencies. Strengthened criminal penalties for IPR infringement went into effect January 1, 1997. But, while the Russian government has begun to pay more attention to enforcement, there are still disappointingly few

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cases in which these penalties have been applied. As the estimated losses attest, piracy of U.S. video cassettes, films, music recordings, books, and computer software is extensive in Russia. Some U.S. companies have had difficulty registering well-known marks. Since mid-1999, U.S. and multinational companies have reported counterfeiting as a serious problem, especially for consumer goods, suggesting that IPR problems in Russia extend beyond copyright protection to include trademark issues as well. Administrative and judicial review bodies are only beginning to become active in IPR protection. The U.S. industry believes that at the prosecutorial and judicial levels, officials often do not consider copyright infringements to be serious offenses.

U.S. investors also consider the Russian court system to be unprepared to handle sophisticated patent cases. However, a higher patent chamber has been established at the Russian Patent and Trademark Agency which should bring greater expertise and efficiency to resolution of trademark and patent disputes.

SERVICES BARRIERS

Discrimination against foreign providers of non-financial services are not so much the result of federal law, as abuse of power, sub-national regulations, and practices that may even violate Russian law. For example, foreign providers of services have sometimes noted discrimination in obtaining licenses from local authorities and often pay fees many times more than those paid by domestic companies.

The federal law on "Banks and Banking Activity of 1996" permits foreign banks to establish branches or subsidiaries in Russia. The law allows the Central Bank to impose a ceiling on the total amount of foreign bank capital as a percentage of the total bank capital in Russia, which is currently set at 12 percent. As foreign banks recapitalized following the financial crisis and Russian banks' capital shrank, as of

September 1, the share of foreign banks' capital increased from 4 to 12.8 percent. The Central Bank of Russia has indicated it will seek a higher quota so as not to impede foreign bank entry. Since 1997 the Central Bank has required foreign banks to have a minimum of ECU 10 million (about \$11.5 million) in capital and to have at least 75 percent of its employees and 50 percent of its management board of Russian nationality. Heads of Russian offices in foreign banks are required to be proficient in the Russian language.

In the insurance sector a new law took effect in October 1999 which implicitly allows majority-foreign owned insurance companies to operate in Russia for the first time, but restricts their total market capitalization and prohibits them from selling life insurance or obligatory types of insurance. The law contains a "grandfather clause" exempting the four foreign companies currently licensed in Russia from these restrictions. Insurance companies with a minority foreign participation (49 percent or less) are not subject to these restrictions.

New tax regulations went into effect January 13, 1999, that provide tax breaks to the Russian film industry until January 1, 2001. Contracts for production, printing and showing of Russian movies (which include the sale of copyrights) will be exempt from the 20 percent value added tax. To qualify as Russian movies, a film must be produced and directed by Russian citizens/companies, have foreign investment of no more than 30 percent and use a crew made up of no more than 30 percent foreign nationals. Fifty percent of the budget must be spent in Russia, and the film must use the Russian language or another language spoken in the Russian Federation. Investments in film production, distribution, and the construction and refurbishment of movie theaters, will be exempt from the profit tax. According to press reports, the draft 1999 budget also allocates 264 million rubles (about \$12 million) for direct support to the film industry.

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The review process for granting licenses to telecommunications providers in Russia through the Ministry of Telecommunications lacks transparency. U.S. telecommunications companies have criticized the five-year term of the licenses, which they argue do not allow them sufficient time to recoup their investment.

Central Bank regulation 721-U effective December 31, 1999 requires that payments of greater than \$10,000 for imported services must receive advance permission from the federal service for currency and export control. While it is intended as an anti-capital flight measure, and while it has been in effect for too brief a period to gauge its real impact, implementation of the rule could disadvantage foreign service exporters to Russia.

INVESTMENT BARRIERS

A Bilateral Investment Treaty (BIT) was signed between the United States and Russia in June 1992. The treaty was approved by the U.S. Senate in October of the same year, but it cannot enter into force until approved by the Russian Duma. The Duma did not actively consider ratification of the BIT in 1999.

Despite the passage of a new law regulating foreign investment in June 1999, Russian foreign investment regulations and notification requirements can be confusing and contradictory. The law on foreign investments provides that a single agency (still undesignated) will register foreign investments and that all branches of foreign firms must be registered. The law does codify the principles of national treatment for foreign investors, including the right to purchase securities, transfer property rights, protect rights in Russian courts, repatriate funds abroad after payment of duties, and receive compensation for nationalizations or illegal acts of Russian government bodies. However, the law goes on to state that federal law may provide for a number of exceptions, including, where necessary, for "the protection

of the constitution, public morals and health, and the rights and lawful interest of other persons and the defense of the state." The potentially large number of exceptions thus gives considerable discretion to the Russian government. The law also provides a "grandfather clause" that existing "priority" foreign investment projects with foreign participation over 25 percent be protected from unforeseeable changes in the tax regime or new limitations on foreign investment. The definition of "priority" projects is not fully clear, although it appears that projects with a foreign charter capital of over \$4.1 million and with a total investment of over \$41 million will qualify. In addition, although the situation has improved over the past few years, foreigners encounter significant restrictions on ownership of real estate in some cities and regions in Russia.

Current Russian legislation restricts foreign investment in the aerospace industry to 25 percent of an enterprise. Foreign investments in the natural gas monopoly Gazprom are limited to 20 percent and in the electrical power giant Unified Energy Systems to 25 percent. However, these limits have not been strictly enforced and current foreign holdings in these two entities is believed to exceed these limits by a small amount. The Duma is also considering draft legislation which would prohibit and/or allow restriction of foreign investment in a wide range of sectors in the economy.

The Russian tax system is a key concern of foreign investors. Although part I of a major tax code reform was passed in July 1998, legislative consideration of the second half of the reform (defining specific rates) was largely stalled in 1999. The Duma did pass changes to the personal income tax which reduced the number of tax brackets from six to three and reduced the maximum tax rate from 45 percent to 30 percent. These changes take effect January 1, 2000. The Duma also expanded the list of goods taxed at the lower 10 percent VAT rate. VAT law amendments signed by Acting President Putin in

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January 2000 are to allow for recovery (via offset against other VAT liabilities) of VAT assessed on capital construction projects, a change long sought by foreign and domestic direct investors, albeit one that will not take effect until January 2001. Crime and corruption in commercial transactions and problems with the implementation of customs regulations also inhibit investment. The lack of rule of law for business opens the door for crime and corruption in commercial transactions, thereby inhibiting investment. In addition, Russian trade and investment would benefit, for example, from improved dispute resolution mechanisms, the systematic protection of minority stockholders rights, conversion to international accounting standards, and the adoption and adherence by companies to business codes of conduct. More transparent implementation of customs and taxation regulations is also necessary.

The government of Russia achieved some progress on foreign energy investment in the Duma with the passage of production sharing legislation in early 1999, following passage of a production sharing agreement (PSA) amendment law in late 1998. These bills were considered necessary prerequisites, though not adequate themselves, for large-scale foreign investment in the Russian oil and gas sector. Additionally, two U.S.-partnered projects, Sakhalin III and Northern Territories, were approved for PSA development by the Duma in 1999, while the Sakhalin II consortium, which also includes U.S. participation, began offshore production in mid-1999. Little subsequent progress was made during the course of 1999 by the government of Russia in the promulgation of "normative acts" necessary to implement an effective PSA regime. In fact, several normative acts have been adopted which are not acceptable to Western energy companies in their current form. Harmonization of the draft tax code with PSA legislation is another issue which requires resolution before substantial foreign investment in Russia's energy sector can be expected. Regulations concerning environmental

permitting and pipeline access remain of concern to potential U.S. investors. Central Bank restrictions on medium-term loans (more than 180 days) of hard currency for purchase of imported inputs have also presented an obstacle to foreign investment projects in Russia's energy sector. Existing PSA legislation retains a 70 percent local content requirement for equipment and requires 80 percent local labor content. There is no reference to the period in which these targets must be achieved, and U.S. companies believe they will be workable provided that subsequent regulations are written in an appropriately flexible way by the Russian government. A separate PSA amendment limits the total amount of foreign investment to 30 percent of Russia's "strategic" oil reserves. The precise meaning and import of this restriction remains unclear.

Regarding purely financial disincentives, foreign investors cite restrictions on profit repatriation with respect to investments in restructured Russian sovereign domestic debt. Russia has assumed obligations under Article VIII of the IMF Articles of Agreement to permit free payment of current transactions, but the Central Bank has gradually been imposing increasing controls on capital flows. Such measures include increasing the percentage of export proceeds which must be sold on the local market (from 50 to 75 percent) and decreasing the time for repatriation (from 14 to 7 days). The Central Bank has proposed increasing the percentage to 100 percent, but the government has not indicated a willingness to move quickly on this proposal. In 1999, the Central Bank ended its practice of dual foreign currency trading sessions (one for exporters/importers and one for other transactions), which had led to some divergence in exchange rates between the two sessions.

Temporary export taxes were adopted beginning in January 1999 as revenue measures that were designed to capture a portion of the windfall profits from the devaluation of the ruble and

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rising world commodity prices. Ten percent export tariffs are levied on the export of scrap from seven metals – copper, nickel, aluminum, lead, zinc, cobalt and titanium – as well as sunflower seeds, rapeseed, soybeans, raw hides and tanned leather, and certain logs (oak, beech, ash). A five percent export tax will be levied on natural gas, refined copper and copper products, nickel ore, nickel and nickel products and fuel oil. The government also imposed a 15 Euro/ton export tax on crude oil exports.

A presidential decree signed in early 1998 provides investment incentives for large investments in the auto industry that meet local content requirements. Although the decree is technically still in place, its implementation has been on hold since the onset of the economic crisis. In practice, U.S. investors in this sector have faced difficulty in obtaining relief promised by the Russian government from local content requirements and for special customs treatment.

AIRCRAFT

Russian tariffs on imported aircraft were raised from 15 to 50 percent in March 1994, and then lowered to the still prohibitive level of 30 percent in 1995, and subsequently to 20 percent in 1999. On January 30, 1996, Vice President Gore and Russian Prime Minister Chernomyrdin concluded a Joint Memorandum of Understanding (MOU) that addresses U.S. concerns about barriers to the Russian civil aircraft market and the application of international trade rules to the Russian aircraft sector. The MOU states that U.S. aircraft manufacturers will be able to participate in the Russian market and share in its growth. The MOU also makes clear that the Russian aircraft industry will in time be fully integrated into the international economy. Russia pledged to undertake the same international trade principles as the United States and many others.

In the interim before Russia accepts its full international trade obligations, the MOU commits Russia to take steps, such as the granting of tariff waivers, to enable Russian airlines to meet their needs for non-Russian aircraft on a non-discriminatory basis. On July 7, 1998, the Russian government issued Resolution 716 which requires Russian airlines to commit to the purchase or lease of Russian-made aircraft in order to receive duty reductions and exemptions for foreign aircraft acquisitions. During the course of 1998 and 1999, waivers were granted to Aeroflot for purchases of foreign aircraft under these conditions.

On January 8, 1998, a federal law on state regulation of the development of aviation was signed. The law stipulates preferential treatment (tax holidays, guarantees on investment) for Russian and foreign investors in aviation-related research and manufacturing ventures. As noted above, the law limits the share of foreign capital in aviation enterprises to less than 25 percent and requires that board members and senior management staff be Russian citizens.

ELECTRONIC COMMERCE

Russian law does not currently provide identical legislative protection for both electronic and paper documents. Settlement issues need to be considered in conjunction with applicable currency control provisions. Registered trademarks are not recognized as entailing rights to the equivalent domain names and the property rights which trademarks secure for their registered owners are currently not protected for the purposes of Internet advertising and commerce through web sites. Tax implications from electronic commerce are unclear.

A number of regulatory efforts are underway with respect to both the Internet and electronic commerce. These include: control of registration of domain names and address spaces for the ru-net by the ministry of telecommunications and information; draft laws

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codifying activities on the Internet; licensing requirements for Internet service providers; licensing and regulating the transfer of information over the Internet; electronic signatures.

The so-called Sorm-2 Act allows the Federal Security Service (FSB) to directly monitor electronic-mail messages by digitally linking its offices with all Internet service providers throughout Russia. Most local ISPS have apparently acceded to Sorm-2 requirements for installation of technical connections with FSB facilities. Whether awareness of enhanced FSB capabilities or underlying enhanced legal authority to monitor communications will discourage electronic commerce remains to be seen.